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SUBJECT: German Banks Take State-Level Bailouts over Federal Funds

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11. SUMMARY: Both Landesbank Baden-Wuerttemberg (LBBW) and BayernLB (BLB) have come to terms with their state governments and other owners on capital injections of billions of euros. Putting state-level taxpayers on the line enabled them to maintain local control by avoiding federal rescue funds and some of the onerous requirements that come with them. LBBW will accede to ownership's demand that it pursue merger talks with the even-more-troubled state bank, BayernLB, in order to create one of Germany's largest banks, but BLB may now not be interested because the Bavarian state government, which is poised to become the majority owner, may want to maintain local control. The surprise losses which led LBBW to seek funding have prompted political outrage and calls for management changes at the bank. END SUMMARY.

State-Level Help Following Global Losses  
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12. After an extraordinary meeting between LBBW and its owners on November 21, Baden-Wuerttemberg Minister President Guenther Oettinger (CDU) announced that the bank will not seek help from the federal government's Financial Market Stabilization Fund (FMSF), and will instead receive a capital injection of 5 million euros (\$8.5 billion) from its three owners: the state government, the city of Stuttgart and the state savings banks. The State of Baden-Wuerttemberg and the savings banks will come up with 2 billion euros (\$2.54 billion) each, while the City of Stuttgart will contribute 950 million (\$1.2 billion). The funding not only puts state taxpayers on the hook, but also uses up all of Stuttgart's reserves. The state and the savings bank will issue bonds to raise their shares. LBBW may also ask for 15-20 billion euros (\$19-25.4 billion) in loan guarantees from either its owners or FMSF.

13. LBBW's Tier One capital ratio had dropped to 6.8% following unexpected losses stemming from the bankruptcy of Lehman Brothers and the economic meltdown in Iceland. LBBW now expects losses of up to 2 billion euros (\$2.54 billion) in 2008 despite a rosy prediction in August from CEO Siegfried Jaschinski that the bank would make a profit for the year. LBBW's losses stem mostly from investments made by recently acquired SachsenLB and LB Rheinland-Pfalz, which has been owned by LBBW since 2005. LBBW maintains that its core business, lending to small and medium-sized businesses in Baden-Wuerttemberg, remains stable and profitable.

14. The news that LBBW would ask for funding came as a surprise, as the bank had fared better in the financial crisis than other state banks and was seen as a candidate to lead consolidation in the state-bank sector. Jaschinski has come increasingly under fire as he has admitted losses piece-meal and rejected suggestions that the bank would need help. Nils Schmid, a leading Social Democratic parliamentarian and member of the administrative council of LBBW, told econ spec that Jaschinski's hesitation had damaged the reputation of the bank and created outrage in the usually

pro-business CDU-FDP government coalition. Schmid nevertheless admitted that raising the bank's Tier 1 capital was necessary for it to remain competitive and to provide the necessary credit to the real economy in the upcoming recession.

State Funding Creates More Flexibility for Merger, but Bavaria Might not be Interested

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¶5. In agreeing to the deal, both LBBW and its owners revealed a desire to maintain the bank's independence which could have been jeopardized had it taken funding from the FMSF. As Germany's state bank sector appears poised for further consolidation, LBBW would have opened itself up to accepting the federal government's decisions on potential mergers. LBBW can now pursue merger talks with BayernLB on its own terms and make its own decisions on any other mergers; a merger with BLB would create Germany's third largest bank overall. All political parties in the Baden-Wuerttemberg state parliament, however, have expressed reservations about LBBW taking over a troubled entity such as BLB.

¶6. Furthermore, the State of Bavaria is now set to become a majority owner of BLB, which means that a merger with LBBW is becoming more unlikely as BLB would not want to be a junior partner in such a setup. Bavaria is spending at least 10 billion euros (\$12.7 billion) on the bailout of BLB and is also not tapping the FMSF in order to rule out federal government influence. It is unlikely that Bavaria would spend money to see important divisions and jobs transferred to Stuttgart later on.

¶7. However, financial experts in Munich believe that BLB has a bleak future as an independent bank, despite the capital injection

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and public guarantees, because its losses are so great and its business model is outdated. The State of Bavaria will recoup its money only if the bank generates a 15 billion euro (\$19 billion) profit in the coming years, a tall order considering economic conditions and the current loss of at least 3 billion euros (\$3.8 billion). Experts question the bank's traditional business model because many of its competitors have taken the medium-sized clients who were traditionally the bank's main market and to whom the bank must now return as it divests itself of the more exotic investment strategies that have brought ruin.

Comment

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¶8. With the capital injection, the state government and LBBW's other owners hope to put the bank on stable ground so that it can help the local economy during the upcoming recession, while Bavaria looks to rescue its own bank. Both cases once again reveal the close relationship between Germany's federal states and their state banks, where the state banks often serve as a tool of the state governments' political and economic power. Both states have taken the risk of using taxpayer money in order to ensure that their banks maintain full flexibility as well as independence from the federal government.

¶9. This cable was collaborated on with ConGen Munich and coordinated with Embassy Berlin.  
POWELL